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Winners and Losers:
Europe and Debt after the Great War and after the Great Recession

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Abstract

Reviewing views once expressed by J. M. Keynes, and adopting some of their great brevity, persuasive prose, and occasionally cryptic logic, this essay compares the economic and political sources and consequences of the Great War boom and bust in Europe to those of the similar if so far less dramatic income swings and debt experiences of Euro area countries.

Keywords: Debt, Convergence, Monetary policy.

JEL: B22, E61

* Università di Torino. I am grateful to Thomas J. Sargent for suggesting that views I expressed about the current European crisis would make it interesting for me to read *The Great Deluge*. I thank the editors of *The Annals of the Fondazione Luigi Einaudi - An Interdisciplinary Journal of Economics, History and Political Science* for the invitation to contribute to a *Reconstruction of Europe* special issue. Any views and errors are my own.

1. Keynes and the Great War debt

In his Introduction to the Reconstruction of Europe essays, published in a series of Supplements by the *Manchester Guardian,* Keynes (1922) downplays the role of "purely economic considerations" as a guide to international policy during the then-current economic crisis. He argues that it is wrong to focus on the temporary malaise of downward economic fluctuation, and confuse them with the "more permanent symptoms of the bad politics of Europe."

The politico-economic problems of the time and Keynes's position in the debate are outlined and discussed in detail by Tooze (2014). Doubting the sustainability of German war reparation payments to the United Kingdom, France, and Italy, and recognizing that they were ultimately flowing to the United States to cover the winning Powers' financial obligations, Keynes thought and argued as an advisor to the British Treasury that renegotiation of both reparations and debt was necessary to forestall the possibility that Britain would be reduced to a state of complete financial helplessness and dependence. The American President Wilson not surprisingly took a different position and saw the situation as an opportunity to establish the United States as the pre-eminent Power in the new world order. The resulting political and economic problems pushed Europe and the world into a prolonged state of crisis, sowing the seeds of the Second World War.

This essay reviews that situation and discusses whether similar issues are relevant to the current European crisis and its possible resolution.

2. Recession, deflation, and public debt

It is a preliminary necessity to introduce basic economic insights that will prove useful in what follows. One is explained well by Keynes (1931). In industrial market economies goods are immediately sold for money, and "an interval of time elapses between production and sale." Production can therefore be brought to a standstill by an expectation that the money price at the date of sale will be lower than the money costs paid during production, which are mostly predetermined by long-term wage contracts. That expectation can be self-fulfilling if lower production, and lower income, exert downward pressure on product-market prices.

Self-fulfilling expectations of low inflation also result from expenditure and price-setting choices, as consumers and investors find it advisable to delay expenditure if prices are expected to decline, and the predetermined 'sticky' prices of some output components are depressed by price-setters' attempt to keep the prices that they set now (but plan to keep fixed for a time) aligned with what they expect their competitors' and suppliers' prices to be in the future.

Keynes also explained and we now know that when money is not linked to species but can be supplied by central banks on a conventional basis then monetary policy can influence the nominal interest rate, aiming to keep the financial cost of production aligned with price-change expectations. The economy can however find itself in a deflationary liquidity trap, where monetary policy is powerless because expected inflation is so low that only unfeasibly negative nominal interest rates could restore incentives to produce.

Public expenditure may in general and in such a situation increase aggregate demand, incomes, and inflation. Additional preliminary points also need to be made regarding the dynamics of the public debt resulting from such expansionary fiscal policy. As emphasized by Sargent (2012) the value of any bond is the present expected value of their repayment, and for public bonds this is the excess of tax revenue on government expenditure. Some of the debt may be denominated in domestic currency, so that the real value of repayment depends on the country's own inflation or deflation. And some is owed to the country's own citizens, who (or their descendants) are the source of tax revenue and the destination of government expenditure. Some debt however may be denominated in foreign currency and owed to the citizens or governments of other countries, raising more difficult economic and political issues.

3. Debt and post-war reconstructions of Europe

The Entente powers accumulated external and not just domestic debt when in 2017, as part of a deliberate high-risk strategy meant to achieve such material superiority as to make it possible to deliver a knock-out blow to Germany, they chose to draw on America resources and pull the United States into war. Tooze (2014) argues that the Wilson administration saw in this situation an opportunity to achieve political supremacy in the new world order. For the United States the issuance and later existence of a large debt stock made it possible to exert political power. Because that source of power would disappear not only if debt were forgiven but also if it could be repaid easily, the Wilson administration exerted its policy-making influence in ways that kept debtor countries' economies in a depressed state and made it difficult for their governments to raise funds other than by exacting war reparation payments from Germany.

In the 1920s depression and debt were economic manifestations of political struggles. This motivated Keynes to emphasize that recognizing and addressing the latter would be key to reconstructing Europe. In practice neither political nor economic issues could be resolved, and the Great Depression of 1929 pushed Europe into a crisis that precipitated into World War Two.

After World War Two a potentially similar situation was managed very differently. Rather than requesting debt repayment the United States deployed the Marshall Plan to finance reconstruction and ensure that supply and demand would meet at a high level. Europe addressed its political problems using economic tools, starting with a common market in coal and steel, progressing towards the 1992 Single Market without barriers to the movement of goods, people, and capital, and culminating with the adoption of a single currency by most European Union member countries in the late 1990s.

The process of market unification was meant to pursue not only economic but also cultural, social, and political goals, using economic policy to achieve through ever closer integration not only growth but also stability and cohesion in Europe. This scheme, originally devised to forestall future wars, was subsequently tasked to ensure commitment to democracy in countries that like Spain, Portugal, and Greece had recently experienced dictatorship, and to ease the post-Communist transition of Central and Easter European countries.

4. Debt in Europe's Economic and Monetary Union

For about ten years now neither growth nor stability or cohesion have characterized a Europe that again finds itself burdened by international financial imbalances, and in need of reconstructing not its material resources (which were not much damaged even by World War One and are as plentiful now as ever) but its institutional infrastructure.

Public debt looms large in a monetary union without fiscal capacity (Sargent, 2012), but its sources and consequences are not always the same. This time income swings and ex post problematic debt stocks did not originate from war victories and defeats. Rather, asymmetric booms and boosts were triggered by the financial market integration afforded by adoption of a single currency and by the financial shocks delivered by the Great Recession of 2008, when much of originally private debt and credit was made public by government bank rescues.

Finance eases and accompanies growth but is also a source of economic and political instability, because credit is extended on expectations that can prove unrealistic ex post. All sides hope to win but only one side can win a war, so not all war debt can always be repaid. Debt is also risky in times of great structural transformation, when expectations are as crucial and can be as misguided as in wartime.

In the late 1990s and early 2000s adoption of a common currency in Europe, enlargement of the European Union and China's access to world trade, and deregulation of the private financial industry triggered domestic credit creation and international financial flows comparable to those seen during the Great War. A portion of international financial imbalances funded 'downhill' investment as capital moved from core countries to peripheral countries where it was scarcer and could promise better returns. Another portion funded public and private consumption in the latter relatively backward countries, where economic and cultural convergence promised better productivity and living standards.

Expectations of productivity convergence were supported in the eyes of both lenders and borrowers by a vision of European integration as a mean to the end of homogeneous and better institutions, cultures, and policies. There are good reasons for capital not to move to poor countries when their poverty is due to inferior technology or institutions rather than to capital scarcity. If adoption of a single currency is a key step towards full integration, which would in turn allow relatively backward countries to develop faster, then capital moves across borders not only to exploit the better investment returns offered by relatively capital-poor countries, but also to finance consumption. Consumption levels should not converge slowly within fully integrated financial markets, and residents of countries where productivity is expected to grow faster should anticipate future income growth in their consumption.

Plausible as it was to expect monetary unification to accelerate productivity convergence across the euro area, no relevant precedent existed for that experiment. Theoretically legitimate expectations of productivity convergence were not confirmed by realizations: within the euro area, there was before the crisis a tendency for countries that accumulated negative international imbalances to experience deterioration of institutional quality as well as of total factor productivity (Bertola, 2013). Adoption of the euro certainly eased international financial integration and generated plausible expectations of faster convergence. However, perhaps because capital inflows relaxed external competitiveness constraints, it did not deliver a realization of that expectation.

5. A fragile Economic and Monetary Union and the Great Recession

With hindsight, adoption of a single currency (but not of a common policy framework in many other policy areas) should not have been expected to imply convergence of productivity-relevant institutions. Convergence is a central feature of the process envisioned by European integration, but it is empirically elusive even within countries, where regions converge only slowly even in a context of much stronger institutional cohesion than in the European Union.

Adoption the euro however did make it easier for financial markets to integrate and accumulate large international imbalances, not all of which were the counterpart of productive capital accumulation. When the Great Recession struck, financial imbalances were inadequately supported by policy-shaping and risk-sharing institutional mechanisms. Within each country economically strong areas and individuals coexist with weaker ones, shocks have asymmetric effects, and a stable set of private and public financial instruments smooth out their implications. Across the borders of euro area countries, conversely, private financial markets proved unable to operate during the crisis, and public financial instruments were deployed only as emergency measures.

Imbalances can remain sustainable across integrating economies if convergence expectations remain stable. But if faith in convergence is loss, then default and disintegration become possible. In the absence of other loss-sharing mechanisms, redefining the real value of legal obligations is more attractive when it becomes more burdensome to honor them, because asymmetric shocks are associated with a decline of the expected rate of convergence and/or coincide with increases of market rates of interest. Debt default, devaluation, and inflation can be deterred by the disruption they imply for pre-existing contractual arrangements and trust, but become attractive when unexpected shocks make disruption and loss of credibility appear less damaging.

The resulting environment, like that of the 1920s, is unfortunately well characterized by what Keynes described as an "atmosphere of distrust and hostility."

6. Debt and power then and now

History did not repeat itself, of course. It would be far-fetched to argue that the German government pursued a dominance scheme like the one that Tooze (2014) attributes to the Wilson administration. The rise of debt during the early phase of economic and monetary union was a market phenomenon, driven in the eyes of both lenders and borrowers by expectations that institutional and economic structures would converge across Europe's core and periphery, and perhaps counted on taxpayer third parties to fill the gap between promised and actual repayment.

In the recent and still current European crisis, however, some of the tensions that large debt stocks generated in the 1920s are present. The actors are not the same. Now China is the lender, not the United States, which financed the allies in World War One but runs large deficits before and after the great recession. Within Europe the ultimate debtors are Spain, Greece, Ireland, Portugal, not Germany. But the issues are very much the same and (as far as sparse historical statistics make it possible to see) the magnitude of repayment promises and problems is similar. Keynes's views on the sustainability of German reparations echo current debates on Greek debt sustainability, and Tooze's (2014) depiction of the Wilson administration financial dominance process has some applicability to the current configuration of European Union policymaking, where co-decision supranational processes hampered by unanimity requirements are superseded by intergovernmental negotiations dominated by the economic and financial strength of creditor countries.

7. Politics and economics then and now

Keynes's views, while debatable and possibly as misguided as some of the similar and opposite ones expressed then and now, are as topical in the current context as they were when he expressed them. In the words of Keynes (1922), "[p]assions of many kinds overwhelm the economic motive in individuals and in nations. Economic self-interest did not prevent the war [.]" Economic self-interest is also not what triggered adoption of the euro, a project that was much more strongly motivated by political compromises about German reunification than by the promise of more efficient market interactions.

The war and the euro did result in the accumulation of debt that afterwards made and makes Europe's reconstruction or further development politically difficult. Like then, so now income distribution pervades economic policy debates.

Tooze (2014) discusses in the detail how macroeconomic policies shifted resources both across debtor and creditor countries, and across groups of individuals within countries. In Entente countries, fiscal austerity and deflation in the 1020s favored capitalists, while workers had to give back some of the welfare they had extracted in wartime conditions of labor scarcity and precious social peace. In Germany and other defeated countries hyperinflation ripped the social fabric and triggered a fight for resources that greatly increased income and wealth inequality.

Similar issues currently play a subdued but obvious role in the conduct of the single monetary policy and in the implementation of fiscal policy constraints. Those who represent the interests of creditor countries naturally favor high interest rates and low inflation even as this makes it more difficult for other countries to service their debt. Those who represent the latter argue for fiscal expansion. Professing faith in market interest rate spreads as regulators of public debt, or advocating pro-cyclical fiscal policy as a remedy to debt problems, may be just a sign of economic ignorance. But such views are likely to derive as much from self-interest as from self-delusion when they are expressed in support of policy prescriptions that benefit creditors and debtors respectively. In the words of Sargent (2017), "[…] government bond holders want a fiscal policy providing them high real returns" and, symmetrically, the governments of debtor countries will prefer policies that reduce repayment burdens.

Categorical positions do not support a constructive debate where all sides aim to persuade and are willing to compromise. The pros and cons of policies differ both across countries and across individuals, and should be debated clearly. As in the 1920s so now Keynes would find it appropriate to organize a forum for the exposition and debate of admittedly National but diverse perspectives on common European issues, as he did when he invited both Anatole France (who failed to deliver an essay) and Gabriel Hanotaux (a French academician "of decidedly reactionary tendencies") to write in the Guardian Supplements on how far international policy should be governed by purely economic considerations.

8. Macroeconomic theory and policy then and now

The same tight monetary policy and fiscal austerity that keep inflation low in creditor countries can drive debtor economies into the deflationary spiral that, as outlined at the beginning of this essay, results from the interaction of production lags and price rigidities. These are certainly more relevant now than in the 1920s, and they also imply that exchange rate flexibility would not be a solution to any of Europe's economic and political problems.

Even though the single currency is the reason of both debt accumulation and divergent monetary policy preferences, if the member countries of the euro area (or perhaps smaller regions within each) used different currencies not only would their monetary policy be easily swayed by poor credibility, but their consumers and producers would be faced by too much uncertainty to pursue long-term investments. A broad and stable macroeconomic environment for dozens of plants, thousands of workers, and hundreds of millions of potential customers over one or two decades is necessary for companies to even consider designing a modern car, a project requiring several years and billions of investment and organization of production in a vast network of component facilities.

When the costs and prices of these and other production activities can be expressed in terms of a common currency within a stable economic area of suitable size, then a modern economy can provide its citizens with technologically advanced goods and well paid employment opportunities. The size of European Nations was suitable at the time of their industrial revolution, but is too small in the 21st century. Then, and now, the price rigidity that eases search and long-term contractual relationships needs accompanying measures: not only monetary policy, but also private and public financial instruments capable of smoothing shocks hitting specific regions, household, or firms within the aggregate economy.

Recent work at the frontier of macroeconomic theory points out that within a currency union insurance against such shocks is more valuable for society than for uncoordinated financial market participants (Farhi and Werning, 2017). The argument is based on aggregate demand externalities in the presence of nominal price or wage rigidities and country-specific consumption pattern. Its logic is the same as that underlying the Keynes (1929) “transfer problem” and indicates that cross-border fiscal stabilization would be just as beneficial for the euro area as within-country redistribution obviously was for traditional Nation-States.

9. Final remarks

The central powers lost the great war, an peripheral countries lost bets placed before the great recession. Both in the 1920s and now it is much easier to outline the problems this generates than to find a practical solution.

The non-economic motivations of the European international integration process and the role of economic forces in its implementation are key both in generating problems and when devising solutions. Europeans should recognize that integration is politically and economically necessary, and work on resolving their cultural differences and conflicting interests through suitable political compromises and appropriately coordinated policies. Because governments are political agents that wield economic instruments, it is certainly far from surprising to see them debate in favor of their citizens' special interest. In bringing economics to bear on politics and policy, however, it is crucial not to dressing self-interested arguments as theoretical truths. It is incorrect and counterproductive to argue that economic integration or low interest rates and inflation benefit everybody, or that a specific set of structural reforms is right for everybody.

A more constructive approach should admit that each integration step and policy action triggers heterogeneous gains and losses, and seek broad and constructive compromises between conflicting interests. Economic research can help if it analyzes how and why reality deviates from the perfect and complete markets that in theory would justify a representative agent approach to policy problems, recognizes that markets and policies not only maximize production but also resolve conflicting interests in its distribution, and characterizes policy tradeoffs in such a way as to build consensus around sound macro policies and structural reforms. Only addressing the distributional implications of economic integration and of policies may help protect EMU from the political and economic risk of a permanent reversal of previous European economic integration trends.

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